Panzirer v. Wolf: A Study in Doctrinal Exegesis

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This article analyzes the Second Circuit decision of Panzirer v. Wolf *wh1ch held that secondary rebance on the integrity of the market could support a cause of action based on Rule JOb-5 of the Securities Exchange Act. The author also examines prior cases relied upon by the Second Circuit and concludes by questioning whether the* Panzirer *holding is justified.*

Relying on the Integrity of the Market

Upon reading a favorable article about a company in the *Wall Street Journal* of September 29, 1978, an investor purchased some ?fits stock. Whethe company initiated bankruptcy proceedings m 1979, sh ued tts officers and accountants under Section lO(b) of the Secuntles Exchange Act,[1] alleging that the company's annual report, issued in August 1978, was fraudulent. Although she had never seen the annual report, her compl aint asserted "that the annual report affected the market, and therefore she had relied on the report through her reliance on the integrity of the market."[2]

The plaintiff also sought to represent the class of investors purchasing the company's stock after release of its annual report. The district judge denied class certification on the grounds that the weakness of her case concerning reliance on the report made her claim atypical and that her lack of credibility made her an inadequate class representative. Affirming the denial of class certification on the basis that the numerous changes in the plaintiff's testimony supported the trial judge's ruling on credibility, the Second Circuit *did* not decide "whether [plaintiff's] weak showing of reliance makes her claim atypical under Fed. R. Civ. P.23 (a) (3)."[3]

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1 15 U.S.C. § 78j(b) (1976).
2 Panzirerv. Wolf, 663 F.2d 365 (2d Cir. 1981).
3 *Id.* at 368 n.4.

presumption of Reliance on Material Fraud

In dismissing the plaintiff's individual suit on summary judgment, the district judge held that primary reliance had been on the newspaper article, and that secondary reliance on the integrity of the market was insufficient to support a Rule 1Ob-5 claim. The Second Circuit reversed, noting that "Defendants have introduced no evidence to contradict [the] chain of causation [implicit in plaintiff's complaint between the fraudulent report and her share purchase],"[4] and holding that "though, at trial, the validity of the chain of causation will be tested, on summary judgment questions about this chain of causation must be resolved in favor of plaintiff, who in the case of a material fraud on the market enjoys a presumption of reliance."[5]

What the Second Circuit Holding Does

Its Effect

This holding not only rejects a doctrinal distinction between primary and secondary reliance, but also establishes a cause of action, in that the plaintiff's allegations of "a material fraud on the market" are held sufficient to resist a motion to dismiss in the absence of evidence from either party. The Second Circuit seeks support for this ruling by reference to its 1976 decision in *Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath,'* which involved an investment manager's mishandling of an investment fund, and the concealment of his previous mishandling of another fund by allegedly false financial statements certified by the defendant accountants. In that case, the district court had granted summary judgment on the ground that the plaintiff could not prove reliance on the financial statements, and the Second Circuit reversed, holding that the plaintiff "need not prove direct reliance, but only causation in fact."[7]

4 */d.* at 367.
aId.
'516 F.2d 811 (2d Cir. 1976).
7 Panzirer v. Wolf, note 2 *supra,* at 368.

Distinguishing *Competitive Associates*

That *Competitive Associates* is distinguishable is clear. The PUr-pose of the accountant's certification is to designate information contained in certified statements as having been processed in ac. cordance with professional standards. Such statements are there.. fore relied upon as setting limits to the impact of manipulative fi. nancial devices resorted to by corporate insiders. Annual reports on the other hand, since they carry no such professional impri: matur,[8] cannot with equal justification be treated as causing the fraud about which they might have given warning. The relevant question thus becomes why the *Competitive Associates* holding governed the decision in *Panzirer v. Wolf.*

The Second Circuit's Rationale

The rationale of the Second Circuit in *Panzirer v. Wolf* is as follows:

> Proving reliance is necessarily difficult where the fraud bas af. fected the market and damaged the plaintiff only through its effect on the market [but] this and other circuits do not require direct reliance where the fraud affects the market, on the ground that an investor relies generally on the supposition that the market price is validly set and that no unsuspected fraud has affected the pnce.[9]

a Since annual reports include financial statements, they do, of course, contain such certifications, and on this basis, the decision in *Competitiv Associates* could have been treated as determinative. Indeed, the first foot-note in *Panzirer* indicates that the accountants were sufficiently concerned at one point to include in their certification a qualification as to the com-pany's ability to function as a going concern, something which st on y suggests a failure to disclose material information. The Second Circuit, however, cites *Competitive Associates* for the proposition that reliance is established when causation in fact is shown. This doctrinal substitution (of proof of causation in fact for reliance) is based on the Supreme Cou 'a decision in *Affiliated Ute Citizens v. United States,* a case analyzed later m this article.

It is in terms of proof of causation in fact functioning as an effective substitute for proof of reliance that the financial statements in *Competitiv Associates* can be distinguished (as being more directly implicated in the fraud) from those at issue in *Panzirer.* Such a distinction parallels the district judge's holding which was based on the contrast between prunary and secondary reliance.

llu• Chip Stamps v. Manor Drug Stores

To ask whether this rationale correctly states the law of Rule lOb-S *is* to ask whether it is consistent with the U.S. Supree Court inion in *Blue Chip Stamps v. Manor Drug Stores*[10] wh1ch held :atthe Second Circuit case of *Birnbaum v. Newport SteeC r .*[11] "was rightly decided, and that it bars respondent from mamta g this suit under Rule lOb-5."[12] *Blue Chip* was handed down m 1975, and litigation during the intervening yea.rhas left ncle r the precise connection between the two propos1t10ns contamed m the holding. Nor is this lack of clarity surprising. In eed, th: doc-trinal distinction between primary and secondary reliance reJect.ed by the Second Circuit in *Panzirer v. Wolf* is itself a model of c an when compared with the distinction drawn by the Sec?nd .C1rcmt in *Birnbaum* between corporate mismanagement, which ts. go:-erned solely by state law, and fraud affecting the market, which ts subject to federal securities legislation. Yet it ws preci.sely on the basis of the latter distinction that *Birnbaum* differentiated those stock transactions that were covered by Rule lOb-S from those that were not.

SEC v. Texas *Gulf Sulphur Co.*

In 1968, *SEC v. Texas Gulf Sulphur* Co.[13] presented the Sec-ond Circuit with an opportunity to define the circumstances under which stock purchases by corporate insiders created liability under Rule lOb-5. The district court had found that the information on the basis of which the stock had been purchased was not material, a finding based on the uncontradicted testimony of expert wit-nesses. The appellate court reversed, however, holding that the materiality of the information at issue was not a matter to be

'Panzirer v. Wolf, note 2 *supra,* at 368.

10 421 U.S. 723 (1975).

11 193 F.2d 461 (2d Cir.), *cert. denied* 343 U.S. 956 (1952).

12 Blue Chip Stamps v. Manor Drug Stores, note 10 *supra,* at 730.

13 401 F.2d 833 (2d Cir. 1968), *cert. denied* 404 U.S. 1005 (1971).

determined by what the parties thought or reasonably could have thought, but that "insider trading activity constitutes . . . the only truly objective evidence of . . . materiality."[14]

As in *Texas Gulf Sulphur*, the decision in *Panzirer v. Wolf* sought to be justified by an appeal to the nature of market activity;[15]

> Zelda Panzirer did not rely on the integrity of the market price because she did not rely on price, but she did rely on the integrity of the market in producing the information reported in the Wall Street Journal. Just as a material misinterpretation or omission is presumed to affect the price of the stock, so it should be presumed to affect the information "heard on the street" which led Zelda Panzirer to make her *losing* investment. u

Unfortunately, this image of the market as providing all participants with equal information, whatever its merits as an analytical model, represents a distortion of reality. The view of the market shared by *Panzirer* and *Texas Gulf Sulphur* is an ideal, and conduct failing to comply with that ideal is treated as justifying *legal* interference with economic activity. Whether decisions embodying that view are consistent with *Blue Chip* remains unclear because Supreme Court decisions interpreting *Blue Chip* remain ambiguous about the extent to which it adopted a doctrine inconsistent with the *Texas Gulf Sulphur* view of the market as something more than a mechanism for the setting of prices.

Sherwood v. Walker

Perhaps the clearest example of the deep common-law roots of such a view is provided by *Sherwood v. Walker* (Rose II of Abalone),[16] the case which held that a mutual mistake of fact about the "substance of the thing bargained for" justifies the judiciary in voiding a contract. *Sherwood v. Walker*, however, also serves as an example of the effective limits to legal doctrine, since almost none of the decisions in which it is cited are resolved on the basis of a finding of mutual mistake of fact.

14 *Id.* at 851.

15 Panzirer v. Wolf, note 2 *supra,* at 368.

16 66 Mich. 568, 33 N.W. 919 (1887).

Sherwood v. Walker is not in the usual case determinative, because the use the language of that decision, the "substance of the thing bargained for" will in almost all cases either be the price or can justifiably be argued to be something reflected in the price to which the parties agreed. *Sherwood,* in short, is a case courts cite rather than apply, not because breeding cows are incapable of being distinguished from cattle raised for beef, but because the *Sherwood* rationale explicitly postulates the possibility of a mutual mistake about price,[17] a hypothetical incompatible with the mechanism of a functioning market. The question raised, therefore, is why inconsistency *with* the functioning of a price-setting mechanism should render a precedent, "revered by teachers of contract law,"[18] ineffective in terms of being applied as well as cited.

Committing Society to the Value of Change

To make possible restrictions on individual behavior, society must agree to at least the possibility of coercing the losing party. Societies permit such coercion to prevent behavior perceived as threatening to the existing social organization. Every market, however, insofar as it operates to produce new categories of consumers and products, is in fact changing the existing economic and social structure. Thus, the scope and pace of this country's industrialization in the last half of the nineteenth century inevitably produced legal attempts by existing communities to restrict economic activity.

The Supreme Court's designation of those attempts as unconstitutional committed our society to the value of change, to a preference for the future possibility rather than the preservation of what is. This commitment, contained in decisions interpreting the commerce clause, transformed a set of diverse political and social communities into a single economic unit; those decisions were accepted on the basis that they were compelled by law, that our Constitution voided not the act of a particular community attempting to regulate the workings of the marketplace, but any *A* or *B* to whom the facts of the decision applied.

17 *Id.* at 576, 33 N.W. at 923.

18 H. Kook & Co. v. Scheinmann Hochstein & Trotta, Inc., 414 F.2d 83, 98 (2d *Cir.* 1969).

Molding Precedents to Get a Desired Result

As lawyers know, however, the foregoing significantly overst the stability of the law, since any precedent can be accommod tea opinion, either by stressing more strongly an element that a by a court that wishes not to overrule a potentially con.fli ·ed considered only in passing in the earlier opinion or by expandi as thuniverse of the factors considered in arriving at the result. pnce e acted by a law opn to subterranean change is residual uncertamty about the applicable standard, an uncertainty whose value inheres in the fact that the law is ultimately a control device an attempt to influence behavior that has not yet occurred. Indeed' the clearer and more uniform a rule is, the more easily it is garded aa for aliy that .cn justifiaby bma ipulated so long as compliance with Its explicit formulation IS mamtained. As our experience with the tax code has demonstrated, any sufficiently uniform formula will at some point be exploited by the development of an application not derivable from the regularities in terms of which the formula was developed. Entrepreneurs, in these terms, can be defined as individuals who develop such variations (and thus change the definition of the operational market), and U.S. law can be defined as a set of formulae that attempts to govern entrepreneurial activity without distinguishing rules applicable to entrepreneurs from those that govern the activities of others.

Status of the Individual

This uniform treatment inevitably creates difficulties when the person whose behavior is being considered is, in vocational terms, an "insider," a "market professional." In terms of Rule lOb-5, *List v. Fashion Park, Inc.*[19] is instructive, since the Second Circuit's basis for refusing recovery in that case appears to have been the plaintiff's status as "an experienced and successful investor."[20] Thus, after holding "[t]he proper test . . . [concerning the meaning of 'reliance' in a case of nondisclosure under Rule lOb-5 to be] whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undis-

[19] 340 F.2d 457 (2d Cir. 1965).

closed fact,"[21] the Second Circuit carefully noted that its test substitute[d] the individual plaintiff for the reasonable man."[22] In other words, although it may be true that the repeated description of "the 'fundamental purpose' of the [Securities Exchange] Act as implementing a 'philisophy of full disclosure.'[23] It states an impersonal market in which the identity of any given individual is irrelevant, it is equally true that the question of the status of that individual in connection with the particular transaction being regarded has been regarded as a relevant consideration in determining liability under that Act.[24]

As the Second Circuit's opinion in *List* demonstrates, courts are capable of deciding cases in accordance with potentially conflicting standards. Thus, what *List* held was that, depending upon the facts of the case, reliance is an issue to be decided in terms of the individual plaintiff rather than the legal construct of the reasonable man. Accountants in certifying financial statements (such as those involved in *Competitive Associates*) make similar professional judgments about choices among generally accepted accounting principles, when more than one such principle is arguably applicable to the transaction being recorded. The distinction between primary and secondary reliance proposed by the district court in *Panzirer v. Wolf* represents an attempt to facilitate such judgments, to prevent a situation in which market losses are automatically converted into a cause of action at law by the simple statement that the purchase was made in reliance on the integrity of the market."

Doctrinal Distinctions and Pleadings

As is usually the case with doctrinal distinctions, the question reduces to one of pleading. Thus, bad the claim been made that

[21] *Id.* at 463.

[22] *Id.*

[23] Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977).

[24] See, e.g., Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir. 1977), which stated that "the diligence of the plaintiff in lOb-5 cases judged subjectively," *id.* at 1016, and cited as an example "a jury instruction that imposed a duty of diligence 'solely under the peculiar circumstances of each case, including existence of a fiduciary relationship . . . position in the industry, sophistication and expertise in the financial community and knowledge of

there was direct reliance on the market price, a case of "fraud on the market" would have been alleged. The precise question raised by the Second Circuit decision, therefore, is whether the fact that no such claim was made justifies application of a doctrinal distinction between primary and secondary reliance to designate circumstances in which claims of reliance on the "integrity of the market" are insufficient to state a cause of action.

Conclusion

The basis for the Second Circuit's refusal to require that "integrity of the market" causes of action include allegations of reliance on the market price itself was the Supreme Court decision in *Affiliated Ute Citizens v. United States*,[25] whose application to *Panzirer* the Second Circuit described as follows:

> Where, as is here alleged, the fraud consists of a failure to disclose, the difficult nature of plaintiff's claim—that if there had been disclosure, plaintiff would not have been harmed—has led the Supreme Court to hold that if the omission is material reliance upon the omission will be presumed.[26]

What *Affiliated Ute Citizens* holds, according to its author, is that "bank agents dealing in the stock of a Ute Indian development corporation had a duty to reveal to mixed-blood Indian customers that their shares could bring a higher price on a non-Indian market of which the sellers were unaware."[27] The corporation in question had been created by the federal government to hold Indian assets as part of a program aimed at ending the system of reservations by acquainting Indians with a market economy. Given that context, it may have been appropriate to assume that Indian and non-Indian markets existed, that they were identifiably separate and distinct entities, and that mixed-blood Indians failed to understand that purchases of commercial property are produced by the belief that buyers willing to pay higher prices can be found.

[25] 406 U.S. 128 (1972).

[26] Panzirer v. Wolf, 663 F.2d 365, 368 (2d Cir. 1981).

[27] Chiarella v. United States, 445 U.S. 222, 250-251 (1980) (Blackmun, J., dissenting).

Absent such a context, however, it is clear that *Affiliated Ute Citizens* cannot be reconciled with the legislative attempt to use the rigors of the marketplace in order to end the status of dependency imposed on reservation Indians.

The fact that *Affiliated Ute Citizens* can be seen to have been correctly decided, however, means neither that the precedent *Wolf* finds in that opinion should be accepted by other tribunals nor that other courts asked to apply Section 10(b) should follow the Second Circuit in finding "no support in the law for the district court's distinction between primary and secondary reliance."[28] Admittedly, particular distinctions detract from the clarity of legal doctrine; the clarity of the concept of a market providing all participants with equal information has the appeal of making unnecessary decisions (e.g., *List*) which are applicable only to the particular plaintiff. Neither of these considerations, however, seems sufficient to justify the rule of law promulgated by *Panzirer v. Wolf*.

[28] Panzirer v. Wolf, note 26 *supra*, at 367.

TRIVIA

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